Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-111

PEOPLES NATIONAL BANK OF NEW JERSEY,

Petitioner,

vs.

JOHN B. FOWLER, JR.

and

MAURICE L. STONEHILL,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
SUPREME COURT OF NEW JERSEY

Petition for Writ of Certiorari and Appendix in Support Thereof

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The Peoples National Bank of New Jersey, a banking corporation organized under the laws of the United States, petitions for a writ of certiorari to review the judgment of the Supreme Court of New Jersey as to the Defendant, Maurice L. Stonehill.

OPINIONS BELOW

The opinion of the Supreme Court of New Jersey (App. A, *infra*, pp. 1a-14a) is reported at 73 N.J. 88. The opinion of the Superior Court of New Jersey, Appellate

Division, (App. B, *infra*, p. 15a) is not reported. The opinion of the Superior Court of New Jersey, Chancery Division, Camden County, (App. C, *infra*, pp. 16a-45a) is not reported.

JURISDICTION

The judgment of the Supreme Court of New Jersey was entered on April 21, 1977. The jurisdiction of this Court is invoked under 28 U.S.C.A. §1257.

QUESTION PRESENTED

1. Whether one who gave his stock endorsed in blank to a borrower who pledged the stock as collateral for a loan and is in all other respects a stranger to the contract between the bank and the borrower, is entitled to raise the defense of violation of Regulation U of the Securities Exchange Act of 1934 and get his stock back under 15 U.S.C.A. §78 cc (b).

STATUTORY PROVISIONS INVOLVED

15 U.S.C.A. §78 aa provides:

> The District Court of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder.

15 U.S.C.A. §78 cc (b) provides:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of . . . any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . .

STATEMENT

Respondent, Maurice L. Stonehill (Stonehill) is the Chairman of the Board of Directors and Chief Executive Officer of Jeannette Glass Co. and was a personal friend of the Defendant, John B. Fowler, Jr. (Fowler).

On May 6, 1970, Fowler borrowed $250,000.00 from Chemical Bank New York Trust Company. As collateral for the loan, Fowler put up 24,013 shares of Jeannette Glass Co. common stock, owned by Stonehill, which Stonehill had made available to Fowler for the borrowing.

Fowler was unable to make payment on the due date, November 6, 1970, and when Chemical indicated it desired re-payment, Fowler and Stonehill agreed that Fowler would move the loan to another bank and use the Jeannette Glass Co. stock as security for the rolled-over loan. Stonehill had been advised by the Chemical Bank that if Fowler's efforts to move the loan to another bank failed, Chemical would be forced to look to Stonehill's collateral for satisfaction.

After Fowler approached several banks in New York City and was unable to obtain a new home for the loan, Fowler approached the Petitioner, Peoples National Bank of New Jersey, located in Westmont, New Jersey, a suburb approximately ten miles from Philadelphia. As a result of negotiations between Fowler and officers of the Petitioner, a loan was closed on March 2, 1971 in the loan amount of $350,000.00. A note was secured by 24,013

shares of Jeannette Glass Company stock owned by Stonehill, and previously endorsed in blank by Stonehill.

There was no correspondence, contact, or negotiation between Peoples and Stonehill prior to or during the making of this loan. Stonehill had known Fowler was attempting to find a new home for the Chemical loan, but had no knowledge or was aware of any details of the transaction with Peoples. He did not know his stock had been pledged with Peoples until a week after the transaction had been concluded, when Fowler advised Stonehill of where his stock had been pledged.

Fowler was almost immediately in default of the obligation; however, Petitioner continued to cooperate with him as to the payment. On May 16, 1972, Petitioner declared a default on the obligation and notified Stonehill that it intended to proceed against the collateral. On May 19, 1972, and after the loan was in default and had been called by the Petitioner, Stonehill through his personal counsel and counsel for the Jeannette Glass Company placed a stop transfer order on the stock pledged to Petitioner, contrary to the terms of the pledge; and Petitioner was unable to sell the collateral to pay off the loan balance.

Petitioner brought suit against Defendant, Fowler, for the balance due on the promissory note in the amount of $246,146.00, and joined Stonehill by reason of the stop transfer order and sought an order for turnover to Petitioner of the Jeannette Glass Company stock pledged for the loan. Stonehill crossclaimed against Fowler for damages as a result of the pledge of stock to the Petitioner for the Fowler loan. Stonehill counterclaimed for the return of the shares of Jeannette Glass Company stock registered in his name. Both Defendants, among other defenses, asserted the defense that the loan contract between Fowler and Peoples was in violation of the Securities Exchange Act of 1934 and was unenforceable.

The Trial Court found that the Chemical Bank loan to Fowler on May 6, 1970 was in violation of Regulation U of the Securities Exchange Act of 1934 and that the $210,000.00 transmitted by Petitioner to the Chemical Bank in order to retire that previous indebtedness, of necessity, by the terms of the regulation, is likewise a violation of the Act by Peoples.

However, in deciding the case, the Trial Court held that Stonehill had no standing to raise the defense of violation of Regulation U by reason that Stonehill was a mere stranger to the entire loan transaction.

The Trial Court entered judgment in favor of Peoples and against Fowler in the total amount of $218,313.36, and directed Stonehill to remove whatever restrictions he has placed on the transfer of the 24,013 shares of common stock with Jeannette Glass Co., registered in his name, so that Peoples may sell the shares and apply the proceeds of sale against the judgment amount.

Both Fowler and Stonehill appealed, and on February 5, 1975, the Appellate Division of the Superior Court of New Jersey, *per curiam*, affirmed the judgment of the Trial Court for the reasons stated by the Honorable William G. Bischoff. Petitioner had not appealed any part of the judgment of the Trial Court.

Initially, the Supreme Court of New Jersey denied a petition for certification (App. D, *infra*, p. 46a). Thereafter, upon reconsideration, certification was granted as to both Fowler and Stonehill, but later vacated as to Fowler (App. E, *infra*, p. 47a, and App. F, *infra*, p. 48a). By order dated May 5, 1976, certification was limited to

consideration of whether there has been a violation of Regulation U and, if there has been, whether Stonehill is entitled to recover his stock (App. G, *infra*, p. 49a).

On April 21, 1977 the Supreme Court of New Jersey modified the judgment of the Appellate Division directing that Stonehill is entitled to the return of his stock, and affirmed the judgment as modified. It based its decision on the *Restatement of Security* (1941), which classified Stonehill as a surety to the extent of the stock pledged by Fowler (App. A, *infra*, p. 9a). The Court then mentioned that "Stonehill's status as a surety, traditionally he would have been designated a guarantor" (App. A, *infra*, p. 9a).[1] By the use of this synonym for surety, the Court converted Stonehill to a guarantor, and as such was found to have standing to raise the defense

1. The Court used Comment g., *Restatement of Security* §82 (1941) to make the transition from surety to guarantor, which comment provides:

> g. *Guaranty.* The term "guaranty" is used in this Restatement as a synonym for suretyship. "Guarantor" is used as a synonym for surety. "Guarantee" is used as a verb meaning to assume a suretyship obligation. The spelling "guaranty" is not used for the verb in the Restatement of this Subject. The terms "suretyship" and "surety" appear more frequently in this Restatement than their synonyms, but the latter are employed to describe certain situations to which they are customarily applied. For example, a suretyship obligation conditioned upon the inability of the creditor to collect from the principal is usually called a guaranty of collection. A contract resulting from an offer to answer for the debt of a principal in a series of credit extensions is generally described as a continuing guaranty . . .
>
> The possible convenience of having certain terms denote only particular types of surety obligations has resulted in some jurisdictions in the use of 'suretyship" as a general term and "guaranty" as meaning some particular type of surety contract. In several states "guaranty" is used as the general term and "suretyship" with a restricted meaning. There has never been general agreement as to which term is to be the broader and which the narrower. Moreover, if both of the two terms are used with a restricted meaning, they do not suffice to cover even the main types of surety obligations.
>
> Suretyship obligations are contractual, and the important point of inquiry should be the precise undertaking of the surety and the duty of the principal. The recognition of the existence of different forms of contractual suretyship and the emphasis upon the obligation assumed in a particular case, are of greater significance than the distribution of labels to the various types of contracts . . .

of Regulation U. The Court relied on a companion case in the United States District Court for the Southern District of New York, where Stonehill, in addition to a pledge of his stock, not only had guaranteed Fowler's liability to a New York bank, but also was a part to a collateral loan agreement (App. A, *infra*, p. 10a). *Stonehill v. Security National Bank and Fowler*, 68 F.R.D. 24 (1975). In *Stonehill*, that court held that Stonehill, as guarantor, participated to a sufficient degree in the loan transaction, and had standing to assert the alleged violation of Regulation U in that case.

REASONS FOR GRANTING WRIT

The decision of the Supreme Court of New Jersey extended the application of 15 U.S.C.A. §78 cc (b) to one not in privity of contract with a lending bank, contrary to the intent of Congress and the rule espoused in *Natkin v. Exchange National Bank of Chicago*, 342 F.2d 675, (7th Cir. 1965).

When Congress enacted the Security Exchange Act of 1934 it specifically provided that the District Courts of the United States have exclusive jurisdiction of violations of the Act and its rules and regulations. 15 U.S.C.A. §78 aa. Subsequent decisions held that violations of the Act, when asserted as a defense in a state court, could be litigated in the state court action despite the provision vesting exclusive jurisdiction in the Federal Courts. *Aetna State Bank v. Altheimer*, 430 F.2d 750 (7th Cir. 1970).

The Securities Exchange Act of 1934 provides that every contract made in violation of the Act or of any rule or regulation is void as regards the rights of any person, who in violation of any regulation, shall have made or engaged in the performance of any such contract. 15 U.S.C.A. §78 cc(b).

Since exclusive jurisdiction for affirmative claims is vested in the Federal Courts, congressional intent and Federal decisions must control where Regulation U is raised as a defense in a State Court. The case of *Natkin v. Exchange National Bank of Chicago*, 342 F.2d 675, (7th Cir. 1965) is directly on point and is controlling. In *Natkin* an action was brought by George and Tillie Natkin against the Exchange National Bank of Chicago alleging that the bank made loans to Ben Notkin in violation of Regulation U of the Securities Exchange Act of 1934. Ben

Notkin had obtained stock from George and Tillie Natkin and deposited the stock as collateral for his loan. The stock certificates were endorsed in blank by the Plaintiffs to make them readily negotiable in the event the bank chose to sell such collateral. There was nothing in the proofs to indicate that the bank in any manner participated in the arrangement between the Plaintiffs and Ben Notkin by which the latter secured the stocks from the Plaintiffs and it was further conceded that there was no contractural relationship between the bank and the Plaintiffs and that the Plaintiffs were strangers to the loan transaction between Ben Notkin and the bank. The Trial Court held no privity of contract existed between Plaintiffs and the bank. The United States Court of Appeals, affirming, held that person who have their stock endorsed in blank to borrowers who pledge same with the bank as collateral for a loan, were strangers to the contract between the bank and the borrower and could not recover from the bank for its alleged violations of Regulation U.

The relationship between the owner of the stock and the bank in *Natkin*, was identical to the relationship between Stonehill and Peoples. Ben and Tillie Natkin were also sureties for the loan to Ben Notkin to the extent of the stock pledged. They, as well as Stonehill, were not parties to any loan agreement nor did they enter into any contract of guaranty. Stonehill had never heard of Peoples, nor knew where his stock was until a week after Fowler had placed his loan.

By the use of definitions found in Comment g. of *Restatement of Security* §82 (1941), the Supreme Court of New Jersey has proceeded to extend the legal concept of "privity of contract" to an owner of stock pledged as security. That Court recognized that a person who permits his stock to be pledged is a surety for a loan to the

extent of the value of his stock. *Restatement of Security* §36 (1941). The Court then equates surety with guarantor and then equates guarantor with a party to a contract.

In the companion case of *Stonehill v. Security National Bank and Fowler,* 68 F.R.D. 24 (1975), the Court found that Stonehill in that loan transaction entered into a direct contractural relationship with the New York bank by his execution of an agreement to guarantee all liability of Fowler, and was also a party to an executed collateral loan agreement. That Court found *Natkin* wholly distinguishable on its facts and held "the clearest indication that there was a contractural relationship and privity between the bank and Stonehill is that the bank is suing Stonehill on the guaranty, whereas in *Natkin*, the bank had no cause of action whatever against Plaintiffs."

The applicability of 15 U.S.C.A. §78 cc (b) to a stranger to a transaction and not in privity of contract, must not be extended by semantics found in the *Restatement of Security* (1941). If Congress had intended to extend the protection of the Securities Exchange Act to one who furnishes collateral endorsed in blank, and closes his eyes to the transaction or manipulations in which the securities are used it would have so provided, and, the clear meaning of the voiding provision cannot be extended by implication. *Levin v. Great Western Sugar Company,* 274 F. Supp. 974 (D.C.N.J. 1967), and *Eastside Church of Christ v. National Plan, Inc.,* 391 F.2d 357 (5th Cir. 1968).

To permits the judgment of the Supreme Court of New Jersey to remain would create a disparity between decisions in the Federal Courts rendered in actions brought to enforce the Securities Exchange Act of 1934 and decisions rendered in State Courts where violation of Regulation U may only be raised as a defense. To permit the disparity to exist, will in certain instances, encourage forum shopping.

If the Supreme Court of New Jersey were to be permitted to formulate its own interpretation of the applicability of the Securities Exchange Act of 1934, with disregard for Federal guidelines, a plethora of suits against banks might well follow from an unwarranted relaxation of the rule of *Natkin* with a consequential adverse effect on banking and commerce. *Levin v. Great Western Sugar Company, supra.*

If the rule of *Natkin* were ripe for change or for waiver in the present case, that change should come about by an Act of Congress. A Federal statute, and the interpretation given to it by Federal decisions, should be given the proper dignity by a State Court, and common law principals of contract law do not change the issues from being a Federal question. *MacGregor v. Westinghouse,* 329 U.S. 402.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

/s/ Morton C. Jacobs
MORTON C. JACOBS

/s/ Igor Sturm
IGOR STURM
Attorneys for Petitioner

JULY 1977.

APPENDIX

APPENDIX A

Argued October 25, 1976 – Decided April 21, 1977.

On certification to the Superior Court, Appellate Division.

Mr. David J. Goldberg argued the cause for appellant (*Messrs. Warren, Goldberg & Berman,* attorneys).

Mr. Igor Sturm argued the cause for respondent (*Messrs. Charles, Sturm & Segal,* attorneys).

The opinion of the Court was delivered by
SCHREIBER, J.

Is an owner of stock, which had been transmitted to a bank as collateral security for a loan to a third person, entitled to the return of the stock because in making the loan the bank violated the federal margin requirements of Regulation U, 12 *C.F.R.* §221.1 *et seq.* (1976), and the usury laws of New Jersey, *N.J.S.A.* 31:1-1 *et seq.*? This issue arose in the context of an action by the Peoples National Bank of New Jersey (PNB) against John B. Fowler, Jr. on a note in the face amount of $350,000, secured by 24,013 shares of common stock of the Jeannette Glass Company (Glass Company) owned by Maurice Stonehill. PNB joined Stonehill as a party defendant to compel him to remove a stop-transfer order placed against the stock with the Glass Company. The defendant Stonehill counterclaimed seeking delivery of the stock certificates of 24,013 shares and crossclaimed against Fowler for any losses to which Stonehill might be subjected in the main suit.

At the conclusion of the trial, the trial court entered a judgment of $218,313 in favor of PNB against Fowler, ordered Stonehill to remove all restrictions prohibiting the transfer of the 24,013 shares of Jeannette Glass Company

common stock, authorized PNB to sell the stock and apply the proceeds to the indebtedness, dismissed Stonehill's counterclaim against PNB, and entered a judgment of $218,313 in favor of Stonehill against Fowler, less the market value of any shares which were not needed to satisfy the principal indebtedness and which PNB was to return to Stonehill.

The Appellate Division affirmed the judgments essentially for the reasons stated by the trial court in its written opinion. We granted Stonehill's petition for certification limited to consideration of whether Maurice L. Stonehill is entitled to recover his stock.[1]

Fowler was the Chief Executive Officer and principal stockholder of a stock brokerage firm, J. S. Love and Co., Inc. (Love). Love, as a member of the New York Stock Exchange, had to maintain certain asset-to-liability ratios in accordance with the Exchange's regulations. When Love's ratios fell below those minima, Fowler borrowed funds, which he in turn advanced to Love, so that Love's qualifications as a member of the Exchange remained unimpaired.

Fowler borrowed $250,000 from Chemical Bank New York Trust Company (Chemical) on May 6, 1970 for a six-month period and deposited 24,013 shares of Jeannette Glass Company common stock with Chemical as collateral for the indebtedness. The stock was owned by Maurice Stonehill, who was the Chairman of the Board of Directors of the Glass Company and owned more than 10% of its issued and outstanding common stock. Stonehill had been a long-time friend of Fowler and as a favor to him (he received no compensation) had forwarded the stock certificates endorsed in blank with appropriate powers of attorney to be used as security in connection with the Chemical loan. The funds from the Chemical advance became part of the working capital of Love and were used in its stock brokerage business for carrying customers' margin accounts and for buying and selling securities.

1. The order granting certification also included the issue of whether there had been a violation of Regulation U. The trial court found Regulation U had been violated and on oral argument PNB conceded that violation. Accordingly, that issue will not be addressed here.

Fowler was unable to make payment on the due date, November 6, 1970, and when Chemical indicated it desired repayment, Fowler searched for other banking sources, principally in New York City, to refinance the unpaid balance of the Chemical indebtedness and to obtain additional funds for Love, which was again in need of an infusion of capital. These efforts proved fruitless. By February 1, 1971, Chemical was demanding payment of the unpaid principal sum of $196,350 plus $12,246 interest and threatening to sell the pledged stock.

Around February 24, 1971, William G. Rohrer, President of PNB, indicated an interest in refinancing the Chemical loan and Fowler met with Rohrer and Francis Mason, a Vice-President, at PNB's office in Laurel Springs, New Jersey, on March 1, 1971. Fowler advised the bank of the Chemical loan, of Stonehill's pledged stock, and of Stonehill's control relationship with Jeannette Glass Company. An agreement was reached under the terms of which Fowler would execute a note in the face amount of $350,000, bearing interest at the rate of 8% per annum, repayable in 11 equal monthly installments of $10,000 commencing April 15, 1971, with the balance due on the twelfth month. The note was to be secured by 24,013 shares of Jeannette Glass Company common stock owned by Stonehill and a $50,000 non-interest bearing certificate of deposit. Fowler also agreed to open a checking account where he would keep a compensating balance of $5,000. The note was prepared and signed at that time.

On March 2, 1971, Fowler closed the loan at PNB. Francis Mason represented PNB. At the closing Mason prepared Federal Reserve Form U-1, which was entitled a "Statement of Purpose of a Stock-Secured Extension of Credit by a Bank" and is commonly known as a Regulation U purpose statement. It was signed by Fowler and Mason. The statement reflected the fact that the collateral for the loan was 24,013 shares of Jeannette Glass Company stock having a market price of $24 per share. The printed form stated that the undersigned (Mason) as a duly authorized officer of the bank was aware that the stock-secured credit may be subject to Regulation U, a regulation which under certain circumstances limited the amount of money which could be borrowed where stock was pledged as collateral for a bank loan. The form further stated that the bank officer must act in good faith, which requires that such officer (1) must be alert to the circumstances surrounding the credit, and (2) has made a reasonable investigation if he has any information which would cause a prudent man not to accept the statement without inquiry. No inquiry had in fact been made by PNB directed to Stonehill, the Chemical Bank, or even to Fowler to determine whether the proposed loan would violate Regulation U.

Fowler also delivered at the closing a letter from Stonehill addressed to PNB, dated February 26, 1971, in which he authorized Fowler to use 48,017 shares of Jeannette Glass Company common stock registered in his name as collateral for a loan which PNB was making to Fowler. This letter had previously been executed by Stonehill, undated and with no addressee, and given to Fowler. Stonehill had known that Fowler was attempting to renegotiate the Chemical loan, but he was not aware of any of the details of the PNB transaction. He did not know his stock had been pledged with PNB until sometime after the

transaction had been concluded. For his part, Fowler admitted that he was familiar with the details of Regulation U and that he was aware at the time the loan transaction with PNB was completed that Regulation U had been violated.

The proceeds from the PNB loan were used as follows:

(a) $210,000 was sent to Chemical to satisfy the balance due on its loan. Chemical in turn transmitted to PNB certificates for 24,013 shares of Jeannette Glass Company common stock registered in Stonehill's name with stock powers of attorney signed by Stonehill.

(b) $50,000 was used to purchase the non-interest bearing certificate of deposit, which was left with PNB.

(c) $5,000 was used by Fowler to open a checking account at PNB.

(d) The remainder, $85,000, was deposited in Fowler's checking account in a New York bank from which the following distribution was made:

(1) $45,000 was used to purchase preferred stock in Love to provide additional working capital for that company;

(2) $12,000 was paid as a finders' fee for arranging the loan;

(3) $25,000 went to the American Bank and Trust Co. in Reading, Pa. to repay a loan that Fowler had previously made on behalf of Love.

Fowler was almost immediately in default when he failed to pay the first installment due on April 15, 1971. However, Fowler thereafter paid six installments. In May 1972, PNB declared the indebtedness in default and applied the $50,000 certificate of deposit against the principal

balance. As of May 16, 1972 the remaining balance due and owing including interest was $246,146.98. PNB was unable to sell the stock collateral because Stonehill's counsel directed the Glass Company's transfer agent not to honor a transfer of the stock.

The trial court found that the PNB loan transaction had violated the Regulation U margin requirements and the New Jersey usury laws.[2] Regulation U, 12 *C.F.R.* §222.1 *et seq.* (1976),[3] had been promulgated by the Federal Reserve Board pursuant to authority granted under section 7 of the Securities Exchange Act of 1934.[4] Section 7 author-

2. The statute in effect on March 1, 1971 limited interest to 6% per annum, subject to the authority of the Commissioner of Banking and Insurance to raise the rate to 8%, *L.* 1968, *c.* 55, §1, which he had done on April 15, 1970. 2 *N.J.R.* 38(a) (1970).

3. Regulation U states:

§221.1 General rule.

(a) *Purpose credit secured by stock.*

(1) Except as provided in subparagraph (2) of this paragraph (a) and in §221.3(q) no bank shall extend any credit secured directly or indirectly by any stock for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time for stocks in §221.4 (the Supplement to Regulation U) and as determined by the bank in good faith for credit subject to §221.3(s) for any collateral other than stocks: *Provided*, That unless held as collateral for such credit on October 20, 1967, and continuously thereafter, any collateral other than stock shall have loan value for the purpose of this part only as collateral for a credit which is not secured by stock, as described in §221.3(s), and any collateral consisting of convertible debt securities described in §221.3(t) shall have loan value only for the purpose of that section, and not for other credit subject to this part.

221.4 Supplement.

(a) *Maximum loan value of stocks.*

For the purpose of §221.1, the maximum loan value of any stock except puts, calls and combinations thereof, whether or not registered on a national securities exchange shall be 35 percent of its current market value, as determined by any reasonable method. Puts, calls, and combinations thereof shall have no loan value.

4. In pertinent part the Securities Exchange Act of 1934, §7, 15 *U.S.C.* §78(g) (1971) provides:

(a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall . . . prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security. . . .

• • • •

(d) It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security in contravention of such rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. . . .

ized the Board of Governors of the Federal Reserve System to enact rules and regulations with respect to the amount of credit which may be extended on any security. Regulation U serves to limit the amount of credit a bank may extend to a borrower where the purpose of the loan is collateralized directly or indirectly by any stock.[5] Operationally, this is accomplished by setting a maximum loan value on the shares pledged as collateral. The primary goal of the regulation was to curb excessive stock speculation credit transactions. At the time of the PNB loan, the maximum amount that could be loaned was 35% of the market value of the stock pledged.[6]

Since Fowler was cognizant of the Regulation U violation at the time of the loan, the trial court refused to void the entire transaction. Instead, it rescinded the contract, denying PNB the right to receive any interest while requiring Fowler to tender to the bank the amount of the principal of the loan. Further, the court held that Stonehill, who had not participated in any of the negotiations preceding the loan, had no standing to raise the defense of a Regulation U violation as he was "a mere stranger to the entire transaction."

5. 12 *C.F.R.* §221.1(a) (1976). Both of these conditions must exist in order for the loan to fall within the ambit of Regulation U.

Since Regulation U only applies to bank loans collateralized by stock where the proceeds are used for the purpose of purchasing or carrying margin securities, these loans are referred to as "purpose loans."

6. This 35% maximum loan value was in effect from May 6, 1970 to December 3, 1971. The present maximum loan value is 50%. 12 *C.F.R.* §221.4(a) (1976).

The factual conclusion that Stonehill had no contractual or other legal relationship with PNB is belied by the undisputed facts. PNB knew that the stock which was being pledged by Fowler was owned by Stonehill. This was evident from Fowler's February 24, 1971 letter to Rohrer (which was received before the loan agreement was made on March 1) in which Fowler advised Rohrer that not only was the stock owned by Stonehill, but also that Stonehill was a controlling stockholder. Because this was control stock, under Rule 154 of the Securities and Exchange Commission, promulgated pursuant to the Securities Act of 1933, only limited quantities could be sold on the American Stock Exchange, where the stock was listed, every six months. 19 *Fed. Reg.* 9375-9376 (1954).[7] Furthermore, at the closing PNB received a letter signed by Stonehill in which he authorized the use of the stock as collateral for the loan. And Francis Mason, PNB's Vice-President, was advised by Chemical of the stock's status when arrangements were being made for transmittal of the stock certificates and satisfaction of the Fowler indebtedness to Chemical.

Stonehill was joined as a party defendant to this litigation because PNB recognized that he was a necessary party. Stonehill's interest in the transaction, as owner of the pledged stock and as surety or guarantor to the extent of the pledged stock, is apparent. Some of his rights as owner of the pledged stock are expressed in the Uniform Commercial Code. *N.J.S.A.* 12A:9-112 provides that:

> . . . when a secured party knows that collateral is owned by a person who is not a debtor, the owner of the collateral is entitled to receive from the secured party any surplus under 12A:9-502(a) or under 12A:

7. Rule 154 was subsequently superseded by Rule 144, 17 *C.F.R.* §230, 144 (1976), effective April 15, 1972.

> 9-504(1), and is not liable for the debt or for any deficiency after resale, and he has the same right as the debtor
>
> (a) to receive statements under 12A:9-208;
>
> (b) to receive notice of and to object to a secured party's proposal to retain the collateral in satisfaction of the indebtedness under 12A:9-505;
>
> (c) to redeem the collateral under 12A:9-506;
>
> (d) to obtain injunctive or other relief under 12A:9-507(1); and
>
> (e) to recover losses caused to him under 12A:9-208(2).

Further, Stonehill's relationship to PNB and Fowler squarely meets, as the plaintiff concedes, the definition of surety as described in §36 of the *Restatement of Security* (1941):

> (1) Where a pledge is made as security for the obligation of a third party, the pledgor is a surety to the extent of the pledged chattel.
>
> (2) Where a third person authorizes the pledge of his chattel to secure the obligation of a pledgor and this fact is known to the pledgee, the owner of the chattel is a surety to the extent of the pledged chattel.

Although the *Restatement* classifies Stonehill's status as a surety, traditionally he would have been designated a guarantor.[8] In the classical suretyship, the surety was a

8. The *Restatement*'s terminology treats a guaranty as synonymous with a suretyship. *Restatement of Security* §82, Comment g. The modern view is to consider the obligation of the third person as contractual and to direct the inquiry to that particular undertaking, usually in the form of a promise to the creditor. *Cf. Bigelow, Bills, Notes and Checks* §447 and §448 at 346 (3rd ed. 1928) with *Restatement of Security* §82.

party to the primary obligation—both the debtor and the surety executing the same instrument and uniting in the same promise. In a contract of guaranty there were two distinct agreements, one made by the principal debtor and the other by the guarantor, the guarantor's contract normally created with the creditor. In the above context, Stonehill's agreement would be considered that of a guarantor. Stonehill offered his Jeannette Glass Company common stock to PNB as collateral for a loan which PNB was proposing to make to Fowler. PNB, relying upon that proposal, made the loan. No one asserts that Stonehill's guarantee required a formal notice of acceptance. Since Fowler did not promise or give Stonehill any consideration, Stonehill was free to withdraw his consent to the use of his stock as collateral. However, once PNB advanced the funds, Stonehill's guarantee to PNB became binding and he could not have then demanded the return of his stock. *Stearns, Law of Suretyship* §2.8 and §4.9, at 71 (5th ed. 1951); *Restatement of Suretyship* §86 (1941); *Restatement of Contracts* §45 (1932); Annot., 6 *A.L.R.* 3d 355, (1966); 38 *Am. Jur.* 2d *Guaranty* §§42, 43 (1968).

Under all these circumstances, Stonehill's standing to raise defenses and assert his claim to his stock is abundantly clear. In a related case involving similar facts, *Stonehill v. Security National Bank and Fowler*, 68 *F.R.D.* 24 (1975), the United States District Court for the Southern District of New York reached the same result.

The trial court relied on *Natkin v. Exchange Nat'l Bank of Chicago*, 342 F.2d 675 (7th Cir. 1965), as persuasive authority to the contrary. In *Natkin* the plaintiffs had delivered stock certificates endorsed in blank to the debtor who pledged these as additional collateral for a loan which violated Regulation U. On its face it appeared that the borrower was the sole owner of the collateral.

The lending bank had no knowledge that ownership had not been transferred to the borrower and the bank in no way participated in the arrangement between the plaintiffs and the borrower. Further, it was conceded that the plaintiffs were strangers to the loan transaction and that no contractual relationship existed between the plaintiffs and the bank. 342 F.2d at 676. Since there was no legal or other contractual relationship between the plaintiff and the bank, plaintiffs could not complain of the Regulation U violation. That case is inapposite, for here the pledgee bank, PNB, knew prior to the loan that the stock belonged to Stonehill, who had consented to the pledge of his stock as security for a loan to Fowler in his letter to the bank dated February 26, 1971. He had the right, in the context of the circumstances, as pledgor, guarantor and surety, to interpose defenses and assert his claim to the unfettered return of his stock predicated on his interest in the transaction.

Stonehill's offer to the bank was to use his shares of Jeannette Glass Company common stock as collateral for a loan to be made to Fowler. Stonehill's letter contained no terms or provisions other than providing that the securities could be sold if Fowler defaulted on payment of the loan and that any other securities pledged by Fowler would be liquidated first. In construing Stonehill's obligation, adherence to the principle that a guarantor's or surety's duty should be strictly construed is in order, particularly where the guarantor or surety is uncompensated.[9] Chief Justice Vanderbilt in *Monmouth Lumber Co. v. Indemnity Ins. Co. of N. America*, 21 N.J. 439, 452 (1956) wrote:

9. The *Restatement of Security* distinguishes between compensated and uncompensated sureties. For example, where time for payment of a debt has been extended an uncompensated surety is discharged whereas a compensated surety is discharged only to the extent that he is harmed by the extension. *Restatement of Security* §129 (1941).

> It has long been settled law that a surety is chargeable only according to the strict terms of its undertaking and its obligation cannot and should not be extended either by implication or by construction beyond the confines of its contract, *Skillman v. United States Fidelity & Guaranty Co.*, 101 N.J.L. 511 (E. & A. 1925); *Boorstein v. Miller*, 124 N.J. Eq. 526 (Ch. 1938); *cf. Southern Surety Co. v. Bender*, 41 Ohio App. 541, 180 N.E. 198 (1931).

Implicit in the pledge as a matter of law was the condition that the loan should conform to and be in accordance with the law, including the Regulation U requirements. There having been a violation of Regulation U, attention is next directed to the effect of that violation on Stonehill's agreement.

The Securities Exchange Act of 934 provides that:

> Every contract made in violation of any provision of this chapater or of any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of . . . any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract. . . . [15 U.S.C.A. §78 cc(b) (1971)]

Since Regulation U imposed the duty on the bank not to extend credit beyond the prescribed guidelines,[10] the Act would appear to invalidate only the lending bank's rights. It is well settled that private causes of action may be

10. Subsequently, Regulation X was adopted which prohibited borrowers from obtaining credit in violation of Regulation U. 12 *C.F.R.* §224 (1976).

predicated on a statutory violation. *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied* 401 U.S. 1013 (1971); 3 *Loss, Securities Regulation* 1757-1763 (2d ed. 1961). Some courts have held that the bank, having sold the collateral and applied the proceeds to the loan, is deprived of its right to recover a deficiency. *Grove v. First National Bank of Herminie*, 489 F.2d 512 (3d Cir. 1974); *Cooper v. Union Bank*, 354 F. Supp 669 (C.D. Cal. 1973), rev'd on other grounds, CCH Fed. Sec. L. Rep. ¶95,384 (9th Cir. 1975); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y.), aff'd mem. 409 F.2d 1360 (2d Cir. 1968), *cert. denied* 396 U.S. 904 (1969). Another remedy which has been applied is to permit the bank to recover the principal on the loan without the interest. *Goldman v. Bank of Commonwealth*, 332 F. Supp. 699 (E.D. Mich. 1971), aff'd 467 F.2d 439 (6th Cir. 1972). However, where the borrower's false and misleading representations to the bank have induced the loan, and the bank has violated Regulation U, the borrower has been denied affirmative relief for damages. *Goldman v. Bank of Commonwealth*, 332 F. Supp. at 706-707; *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. at 90.

The trial court equated Fowler's conduct with that of the fraudulent borrower because Fowler, a sophisticated securities dealer, knowing that his proposed loan with plaintiff violated Regulation U, intentionally did not disclose that fact to PNB. But Stonehill cannot be placed in the same *pari delicto* classification. He was not guilty of any wrongdoing in connection with the PNB loan. He was an uncompensated gratuitous guarantor and the reasons for denying Fowler relief would be inapplicable to Stonehill, for Stonehill's obligation to PNB arises out of an independent, albeit subordinate, contract.

It is a general rule that, if the condition upon which the guarantor agrees to become bound is not complied with, the guarantor is discharged. *Brandt, Law of Suretyship and Guaranty* §350, at 471 (1878).[11] We find that where the uncompensated guarantor's obligation contemplated a bank loan which would be made in accordance with the law, the bank's violation discharges that obligation and the pledgor is entitled to the return of his stock.

The judgment of the Appellate Division is modified in accordance with this opinion, and as modified affirmed.

11. A comparable rule may be found in §124 (1) of the *Restatement of Security* (1941) which provides that:

> Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety.

APPENDIX B

Argued January 21, 1975—Decided.

Before Judges Halpern, Crahay and Ackerman.

On appeal from Superior Court, Chancery Division, Camden County.

Mr. Clarence P. Reberkenny argued the cause for appellant Fowler (Messrs. Hyland, Davis & Reberkenny, attorneys).

Mr. David J. Goldberg argued the cause for appellant Stonehill (Messrs. Warren, Goldberg & Berman, attorneys).

Mr. Igor Sturm argued the cause for respondent (Messrs. Charles & Sturm, attorneys).

PER CURIAM

The judgment under review is affirmed essentially for the reasons stated by Judge Bischoff in his written opinion.

Affirmed.

A True Copy
Elizabeth McLaughlin
Clerk

APPENDIX C

Decided: August 2, 1973.

Messrs. Charles, Pluese & Sturm
By: Igor Sturm, Esq.,
Attorneys for Plaintiff

Messrs. Hyland, Davis & Reberkenny
By: Clarence P. Reberkenny, Esq.
Attorneys for Deft., Fowler

Messrs. Warren, Goldberg & Berman
By: David J. Goldberg, Esq.
Attorneys for Deft., Stonehill

Bischoff, J.S.C.

This is an action instituted by Peoples National Bank to recover the balance due and owing together with interest and attorneys' fees on a promissory note executed by defendant, Fowler, and for the turnover of certain stock owned by defendant, Stonehill, which was pledged as collateral for the aforementioned note. Defendant, Stonehill, has counterclaimed for the return of the pledged stock and has crossclaimed against Fowler for losses sustained as a result of the sale or disposition of his stock used as collateral for the loan. Both defendants assert the defense of usury and both allege the note to be void as a result of a violation of Regulation U of the Securities & Exchange Act of 1934, 15 U.S.C.A. 78A.

The facts are largely undisputed, and I find them to be as follows:

On April 30, 1970, defendant, Fowler, was the Chairman of the Board of Directors of J. S. Love & Co., Inc., a New York City stock brokerage firm which was a member firm of the New York Stock Exchange. According to a

Statement of Financial Condition dated as of April 30, 1970, said stock brokerage firm did not meet the net capital requirements prescribed by the New York Stock Exchange. A Special Operations Questionnaire submitted by the company to the New York Stock Exchange for the month ending April 30, 1970 showed the amount of net capital to be $228,802.00 less than the minimum requirements.

The defendant, Fowler, arranged to borrow and did borrow on May 6, 1970, the sum of $250,000.00 from a New York City bank, Chemical Bank New York Trust Company (now Chemical Bank), which he deposited in his subordinated account in said J. S. Love & Co., Inc. As collateral for such loan, Fowler put up 24,013 shares of Jeannette Glass Company common stock, owned by the defendant, Stonehill, which Stonehill had made available to Fowler and for which Stonehill had executed a Letter of Consent to Pledge and Hypothecation. Stonehill loaned the aforementioned shares to Fowler as a favor, with the understanding that Fowler would return the stock to him shortly. Fowler testified that he agreed that he would return the stock to Stonehill in not more than six months. Said loan was made to provide the capital required for the conduct of the brokerage business of J. S. Love & Co., Inc. in order to enable said company to meet the required capital and thus be allowed by the Exchange to continue in business. The brokerage business transacted by said company involved the purchasing and carrying of stock traded on national securities exchanges for the accounts of its customers. By the terms of the promissory note given to Chemical Bank, payment of that note was due on November 6, 1970. Fowler was unable to pay the loan on that date.

Stonehill was advised by the Chemical Bank that if Fowler's efforts to move the loan to another bank failed,

that the bank would be forced to look to his collateral for satisfaction. By letter dated February 1, 1971, Fowler was advised by Chemical Bank that it demanded payment of the principal sum of $196,350.39 plus interest.

In the latter part of February, 1971, as shown on the Statement of Financial Condition, as of February 26, 1971, J. S. Love & Co., Inc. was again in need of an infusion of additional capital. Borrowings by Fowler from other sources to provide capital at previous times also were in a payment due status. The stock exchange was again threatening suspension of business. Fowler determined that he should seek a loan or loans of $600,000.00 to pay off existing borrowings, especially the Chemical Bank loan, and to provide additional new equity capital for his brokerage firm. Fowler approached several banks in New York City and, although one had indicated a willingness to loan he was finally told that in view of the failures of many stock brokerage firms that a policy had been adopted to the effect that no loans were going to be made to Wall Street brokers.

With New York banks apparently closed to him, Fowler contacted a friend in New Jersey, one Karl Pettit, who, in turn, communicated Fowler's need to one Tyler McNutt, and Fowler was told to see William G. Rohrer, President of plaintiff bank. As a result of a discussion with Mr. Rohrer on February 24, 1971, Fowler wrote a letter of even date therewith to Mr. Rohrer as President of the plaintiff bank in which he stated a desire to borrow $600,000.00 for a period of six months to be collateralized with 48,017 shares of Jeannette Glass Company common stock, registered in the name of Maurice Stonehill, under a hypothecation letter given to him by Stonehill for the purpose of such borrowing. Fowler further informed Rohrer that the proceeds of the loan would be used to pay off existing

borrowings and the letter was written on the letterhead of J. S. Love & Co., Inc. showing its Wall Street area address and which also contained the legend: "Members New York Stock Exchange". Fowler further stated in said letter that he was the Chairman, Chief Executive Officer and controlling stockholder of said firm. The letter also informed plaintiff bank that the Jeannette Glass Company stock was listed on the American Stock Exchange, was fully registered, was not legend stock, but was owned by a controlling stockholder and would come under SEC control stock regulations.

In order to pay off the Chemical Bank loan through a loan from some other bank, Fowler had Stonehill sign several hypothecation letters the body of which were typed but which left blank the date and name of the addressee. After plaintiff bank had indicated its receptiveness to the loan, Fowler dated the hypothecation letter and addressed it to plaintiff bank and delivered the same to it as part of the loan transaction.

On March 1, 1971, Fowler visited the plaintiff bank. Also present were Karl Pettit and Tyler McNutt.

A discussion ensued at the desk of Mr. Rohrer and Mr. Rohrer called in Francis V .J. Mason, a bank vice-president who had no prior knowledge of Mr. Fowler or the proposed loan transaction. At that time, Mr. Mason was handed the said letter written by Fowler to Mr. Rohrer under date of February 24, 1971 and a further discussion ensued out of which an agreement arose to loan Fowler $350,000.00. Because the prevailing interest rate of 8% was not attractive to the bank, Fowler suggested, and the Bank agreed, to increase the amount of the loan from the desired $300,000.00 to $350,000.00 with the additional $50,000.00 being used by Fowler to purchase a non-interest bearing certificate of deposit from the Bank. This certificate of deposit was held by the Bank as additional collateral.

Further, the loan would be for a one year term payable in equal monthly payments of $10,000.00 with a balloon payment at the end of one year. In regard to collateral, plaintiff bank was to receive from Chemical Bank the Stonehill stock it was holding on its loan upon plaintiff bank transmitting $210,000.00 to Chemical Bank as payment in full on the outstanding loan.

The note which plaintiff bank had Fowler execute called for interest at 8% per annum on $350,000.00 and called for the first monthly payment to be due and payable on April 15, 1971.

Mr. Mason prepared or caused to be prepared a note, a Regulation U purpose statement, and the bank's own form of hypothecation agreement which it desired to have Fowler have executed by Stonehill in lieu of the one Fowler had presented to the plaintiff bank. Fowler signed the note and Regulation U purpose statement and took away with him the bank's hypothecation statement for later transmittal to Stonehill for execution. Stonehill never executed the bank's form of hypothecation agreement.

The proceeds from the Peoples Bank loan were used as follows:

(a) $210,000.00 was sent by Peoples Bank by way of wired transfer to Chemical Bank to pay off the balance of the Chemical Bank loan.

(b) $50,000.00 was used to purchase the non-interest bearing certificate of deposit.

(c) $5,000.00 was used by Fowler to open a checking account at plaintiff bank.

(d) The remainder was sent by Peoples Bank to Fowler's checking account in New York from which the following distribution was made:

(1) $45,000.00 was used to purchase preferred stock in Love and Co. to provide additional working capital for that company;

(2) $12,000.00 was paid to Pettit and McNutt as a finders fee for arranging the loan;

(3) $25,000.00 went to repay a loan that Fowler had previously made on behalf of Love and Co.

Plaintiff bank is a national bank organized under the laws of the United States and, as such, is and was at all times material hereto engaged in the making of loans in the ordinary course of its business. As a national bank, it is presumed to be, and it is hereby found to be, familiar with the regulations of the Board of Governors of the Federal Reserve System promulgated under the authority of 7(a) of the Securities and Exchange Act of 1934, 15 U.S.C.A. §78g(a), particularly Regulation U, the regulation prohibiting banks from extending any credit secured by any stock registered on a national securities exchange in an amount exceeding the maximum loan value of the collateral as prescribed from time to time by said Board of Governors.

Neither Mr. Mason or Mr. Rohrer, the only bank officers who approved and processed the loan documents, ever inquired into or investigated the question of a possible Regulation U violation.

The Regulation U purpose statement which the bank had Fowler execute was filled in by Mr. Mason and other bank employees. The space reserved for describing the purpose of the loan was not filled in at all. Under the circumstances, said purpose statement could not be deemed to have been accepted in good faith.

Prior to the making of the loan, the defendant, Fowler, was not personally known to the plaintiff bank or to any of its officers who approved or processed the loan.

The credit or loan to Fowler was made for the purpose, insofar as Fowler was concerned, of paying off existing borrowings and to provide J. S. Love & Co., Inc. with further equity capital. Those borrowed monies had gone into J. S. Love & Co., Inc., in order to provide it with the capital that the Exchange deemed necessary to allow it to continue to purchase and carry securities registered on national securities exchanges for the accounts of its customers. Further, said credit or loan was secured directly by 24,013 shares of Jeannette Glass Company common stock, and, the maximum loan value of such stock under the then current supplement to Regulation U would have been 35% of its market value. In actuality however, the loan value extended was nearly double that percentage limit and, as filled in by the bank's own employee or employees, the Regulation U purpose statement showed it to be 70% of market value.

Fowler was almost immediately in default of the obligation; however, plaintiff continued to cooperate with him as to repayment. On May 1st, 1972 plaintiff declared a default on the obligation and applied a $50,000.00 certificate of deposit against the principal balance, which certificate had been purchased by Fowler and assigned to plaintiff as security. Prior to calling of the loan by plaintiff, Stonehill had placed a stop transfer order on the stock pledged to plaintiff, contrary to the terms of the pledge; and plaintiff was unable to sell the collateral to pay off the loan balance. There is a balance due on the promissory note in the amount of $246,146.00, together with interest and attorneys' fees.

The issues presented by this matter are as follows:

1. Whether this Court has jurisdiction over a suit on a promissory note even though answers by defendants have been filed alleging substantive violations of the Securities

Exchange Act or is sole jurisdiction vested in the United States District Court?

2. Whether defendant, Fowler, should be estopped from raising the defense of usury since he suggested to plaintiff that he purchase a non-interest bearing savings certificate with plaintiff bank, thus making the transaction more attractive to the plaintiff bank?

3. Whether a loan made on March 1, 1971 of $350,000.00 at eight (8) per cent with $50,000.00 of said loan being used by borrower to purchase a non-interest bearing savings certificate of the lender constitutes usury?

4. Whether defendant, Stonehill, who owned the stock pledged by Fowler, has the legal right to raise the defense of violation of Regulation U?

5. Whether defendant, Fowler, should be estopped from raising the defense of plaintiff's violation of Regulation U; if at the time of the loan transaction, he knew that the loan and pledge of stock was in violation of Regulation U?

6. Whether a loan of $350,000.00 with a pledge of stock valued at $387,239.69 violates Regulation U (12 C.F.R. §221.1 et seq.) and is therefor void and unenforceable?

JURISDICTION

Both defendants contend that this Court lacks jurisdiction to hear this matter.[1]

They argue that plaintiff has violated Regulation U (12 C.F.R. §221.1 et seq.) which was promulgated by the Board of Governors of the Federal Reserve System pursuant to authority granted in the Securities Exchange Act of 1934 (see 15 U.S.C.A. 78 gj). They further argue that pursuant to 15 U.S.C.A. 78aa exclusive jurisdiction in such matters lies in the federal courts, which section provides in part:

> "The District Court of the United States ° ° ° shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, *and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder* ° ° °" (Emphasis added).

The matter before me is not a suit to enforce "any liability or duty" created under the Securities Exchange Act of 1934 "or the rules and regulations created thereunder." This is an action to recover monies due to plaintiff as a result of a default on a promissory note. Plaintiff did not *initiate* this action on a federal statute or regulation.

In *Aetna State Bank v. Altheimer*, 430 F.2d 750, 754 (7th Cir. 1970) the court stated, when confronted with a jurisdictional argument premised upon 15 U.S.C.A. §78aa, ° ° °

1. I might add, at this juncture, that this matter was originally commenced in this Court but removed to the Federal District Court, only to be remanded back to this Court. Also, Fowler's answer, which accompanied his removal action, set up violations of Regulation U. Furthermore, shortly before trial, Stonehill filed an action in the United States District Court to declare this transaction void and unenforceable as a result of the violations of the Securities Exchange Act and sought an injunction from the United States District Court against this Court from proceeding in this matter, asserting that sole jurisdiction was in that Court. The injunction was denied; however, the complaint is still pending.

> "that even if it be assumed that the act precludes a state court from entertaining an action insofar as relief is sought, nothing in that section prevents the state court from considering questions ° ° ° which are introduced by way of defense, and failure to do so would violate the supremacy clause." (cf. *Shareholders Management Company v. Gregory*, 449 F.2d 326 (9th Cir. (1971), where the court stated at 327: "We perceive no jurisdictional barrier to the state court's entertaining and adjudicating the merits of appellants' defense based on the interpretation of the Securities Exchange Act 1934.")

Now defendant, Stonehill, urges that the fact that this matter was originally removed to the United States District Court and was remanded does not detract from his attack on this Court's jurisdiction to hear and determine this matter. I cannot accept this argument. Defendant, Fowler, raised the issue of alleged violations of Regulation U in the answer he filed with the United States District Court, as well as his brief in opposition to plaintiff's motion to remand, yet the matter was remanded to this Court. Stonehill, in a separate action in the United States District Court, sought to have the loan transaction declared void and unenforceable and further sought to restrain this proceeding. The United States District Court refused to restrain this Court from proceeding to trial.

To accept the contention that this Court lacks jurisdiction over this matter would deny plaintiff access to the Courts of this State. There are several ways to invoke the jurisdiction of the United States District Court, one of which is a suit between citizens of different states involving a controversy in excess of $10,000.00. Defendant, Fowler, is a resident of Pennsylvania, but if he were a resident of New Jersey, plaintiff would not have access to the federal Courts since his suit is solely one for money damages. The other

access to federal court would be by invoking "federal question" jurisdiction. Plaintiff would be denied access to federal court in this instance because his suit is to recover monies due upon a default on a loan.

Defendant, Fowler, urges that the decisional law in New Jersey reveals a policy by our Courts to avoid questions involving securities regulations due to the fact that Congress has preempted the field. *Trad v. Hodes*, 72 N.J. Super. (Law Div. 1962); *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431 (Ch. Div. 1952, aff'd 12 N.J. 467 (1953); *Travel Agts. Malpractice v. Regal Cul. Soc., Inc.*, 118 N.J. Super. 184 (App. Div. 1972).

I find these cases to be inapplicable to the matter now before me.

Accordingly, I hold that I have jurisdiction over the subject matter of this lawsuit.

USURY

Both defendants have raised the defense of usury. The factual situation which provokes this issue is undisputed. The parties negotiated for a $300,000.00 loan. When Mr. Rohrer indicated that he was not particularly interested in the proposition for the loan, that he could place money locally at 8%, the defendant, Fowler, then suggested raising the amount of the loan to $350,000.00. With the extra $50,000.00 Fowler indicated he would purchase a $50,000.00 non-interest bearing certificate of deposit from Peoples National Bank which he would then deposit with Peoples National Bank as additional collateral for the loan. It is contended by the defendants that the computation of 8% interest on $350,000.00, when but $300,000.00 was actually advanced to the borrower, gives the bank a rate of interest in excess of 9%.

The defendant argues that under the provisions of N.J.S.A. 31:1-3 all interest paid on the loan should be deducted from the principal; and if a judgment is to be rendered for the plaintiff and against the defendants, it should only be for the balance then due.

Plaintiff in resisting this defense contends first that the loan was not usurious and that even if it were usurious the defendant, Fowler, is estopped to raise this defense, since it was he who suggested the plan, and that he was a party to it.

The statute concerning rates of interest, as it was in effect on March 1st, 1971, reads as follows:

> "(a) Except as otherwise provided by law, no person shall, upon contract, take, directly or indirectly, for loan of any money, wares, merchandise, goods and chattels, above the value of $6.00 for the forbearance of $100.00 for a year, and after that rate for a greater or less sum or for longer or shorter time; *and except further, that the Commissioner of Banking and Insurance, with the advice of a special advisory board constituted as hereinafter provided, may by regulation adopted, amended and rescinded from time to time, provide that the value which may be taken for any such loan shall be a value more than $6.00 but not more than $8.00 for the forbearance of $100.00 for a year, as shall be prescribed in such regulation, and after that rate for a greater or less sum or for longer or shorter time.*"

Pursuant to said statutory authority, James C. Brady, Jr., Commissioner of Banking, adopted an emergency regulation which was filed on April 15, 1970 as R.1970 d41 (2 N.J.R. 38(a)) increasing the interest rate to 8%. Said regulation provides:

"INTEREST RATE. The maximum rate of interest to be charged, taken or received, upon a loan or forbearance of any money, wares, merchandise, goods and chattels, made on or after April 16, 1970 shall be 8% per year . . . This regulation has prospective effect only."

By regulation filed April 6, 1971, as R.1971 d.49, (3 N.J.R. 74(a)), the Commissioner decreased the interest rate from 8% to 7½%. Said regulation provided:

"INTEREST RATE. The maximum rate of interest to be charged, taken or *received*, upon a loan or forbearance of any money, wares, merchandise, goods and chattels, consummated on or after April 7, 1971, shall be 7½% per year." (Emphasis supplied)

It is to be noted that unlike the regulation of April 15, 1970, the subsequent regulation did not contain any statement that the regulation had only *prospective* effect.

The note was dated March 1st, 1971 and the first installment of interest was payable April 15, 1971. The defendant contends that since the effective date of the amended regulation was prior to the date of the first payment of interest, the maximum permissible interest rate was 7½%. I disagree. It is well-settled that if a note is valid when made, no subsequent act can make it usurious. *Shalit v. Investors Savings & Loan Ass'n.*, 101 N.J. Super. 283 (Law Div. 1968).

We proceed to a consideration of the basic law and defense of usury.

In order to sustain a defense of usury there must be an intention to charge interest at a rate in excess of the statutory minimum. *Ditmars v. Camden Trust Co.*, 10 N.J. Super. 306 (Ch. Div. 1950), aff'd., modified, and remanded

10 N.J. 417 (1952). "Usury must be proved beyond a reasonable doubt and the court may consider the question of whether the charge of usury is made in good faith or as an expedient seized upon to escape liability." *Ditmars v. Camden Trust Co.*, supra.

The approach of the Supreme Court to the question of Usury in the Court of Chancery appears from their opinion in the case of *Ditmars v. Camden Trust Co.*, 10 N.J. 471 (1952) at page 498:

"• • • the burden of proof of the corrupt bargain (beyond a reasonable doubt) is upon the one who asserts the claim of usury, (citation omitted). If neither party intend it, and act bona fide and innocently, the law will not infer a corrupt agreement. (Citation omitted). Thus where, as in this case, the illegal interest is received by mistake or a miscalculation made in good faith, and not by intent to evade the usury laws, the transaction itself is not usurious and forfeiture of legal interest does not follow although the illegal interest received must be repaid. (Citation omitted). This is even more evident in equity, for there relief will only be granted the borrower on condition that he do equity 'by repaying his creditor what is justly and in good faith due, that is, the amount actually advanced *with lawful interest*."

The public policy of this State with respect to the defense of Usury clearly appears from the action of the Legislature in amending N.J.S.A. 31:1-1A, effective July 6, 1972, This amendment provides that the limitation on interest rates applies to loans when the total amount or the value of which is *less* than $50,000.

Fowler testified at the trial "that he knew that the offer to purchase the non-interest bearing certificate of deposit in

effect raised the interest rate to be paid above the legal limit." He is a man extremely knowledgeable in the area of finance and banking. He is sophisticated in money matters. His world is that which deals in the New York Stock Market and matters of high finance. He testified his brokerage firm was floundering and needed financing, that many banks in New York refused to loan required funds.

Usury laws exist to protect oppressed borrowers. *Ferdon v. Zarriello Bros., Inc.*, 87 N. J. Super. 124 (Law Div. 1965). Fowler cannot be placed in this classification. I conclude that he offered the bargain to the plaintiff fully aware of the usury laws of this State and the fact that the scheme constitutes a violation of the law.

I have no difficulty in finding that the burden of proof has been carried and that the loan did in fact violate the laws of our State in that it exacted a rate of interest in excess of the maximum permitted.

Fowler argues that public policy of this State is so violently opposed to usury as to permit one of the parties to a corrupt bargain in violation of such laws to avoid all liability for interest.

> "In most of the jurisdictions wherein the question has arisen the courts have taken the view that a borrower's initiation of, or fraud contributing to, a usurious transaction estops the borrower from setting up the defense of usury. The reasoning underlying such view is that to hold the transaction void would permit the borrower to take advantage of his own wrong." 16 ALR 3d 513.

However, Fowler argues that New Jersey is one of the minority states which permit one who actually instigates the illegal arrangement to avoid all liability, relying on *Riley v. Hopkinson*, 82 N.J. Eq. 469 (1913).

My research has failed to show that this case has ever been cited for the proposition advanced by the plaintiff. To the contrary, the cases since *Riley* have taken a different approach to the problem. For instance, the burden of proof of usury is beyond a reasonable doubt. The equitable approach to usury as set forth by the Supreme Court in the *Ditmars v. Camden Trust Co.* case, supra, requires the borrower in violation of the usury statute to pay the legal rate of interest. The recent amendment to the usury statute indicates a public policy to protect only the small borrower and not one dealing in loans of $50,000 or more. The defense of usury is looked upon with disfavor when made as an expedient to deny liability. *Ditmars v. Camden Trust Co.*, supra.

I, therefore, find that the public policy of the State does not favor relieving one who knowingly engages in a usurious contract and one who, in fact, instigates the arrangement from all liability for interest when a loan of $300,000 is involved. Fowler contends that he should be permitted to credit against the principal all interest payments made on the note. While I have no difficulty finding that the arrangement for the payment of interest resulted in the exaction of interest in an amount in excess of the maximum permitted by law, I find that Fowler should not be permitted to use the very device suggested by him to avoid all liability for interest.

For reasons which will appear later in this opinion, the resolution of the issue of usury will not be the basis of the final judgment to be entered herein. If it were, I would hold Fowler liable for interest on $300,000 at the rate of 8% from the date of the note, giving credit to him for all interest paid against the total amount of interest then due.

It would naturally follow that the liability assessed against Stonehill's collateral would be adjusted accordingly.

However, my determination of the issue raised by Regulation U makes such calculations unnecessary.

REGULATION U

The final issue involved in this matter is the alleged violation of Regulation U (12 CFR 221 et seq.). Both defendants contend that the loan by plaintiff to Fowler with the accompanying pledge of the Jeannette Stock owned by Stonehill was a violation of this regulation.

Pursuant to 15 U.S.C.A. §78g(a) the Board of Governors of the Federal Reserve System is authorized to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security) • • •." Pursuant thereto the Board of Governors promulgated Regulation U (12 CFR 221.1(a)) which reads in part:

> "• • • no bank shall extend any credit secured directly or indirectly by any stock for the purpose of purchasing or carrying any margain stock in an amount exceeding the maximum loan value of the collateral as prescribed from time to time for stocks in §221.4 (the supplement to Regulation U) • • •.
>
> For the purpose of §221.1, the maximum loan value of any stock, whether or not registered on a national securities exchange, shall be 35 percent of its current market value, as determined by any reasonable method. 12 CFR §221.4(a)."

The Securities Exchange Act of 1934 (15 U.S.C.A. §78ee) specifically provides in part:

> "• • • Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of or the continuance of any relationship or practice in violation of, and provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation • • •."

Both defendants argue that the loan transaction should be declared void. Their argument is premised upon the fact that at the time of the loan of $350,000 to Fowler the Jeannette Stock had a market value $600,325 and the loan by plaintiff was $350,000. According to Regulation U (12 CFR §221.4) the loan could only have been for 35 percent of that amount, which amounts to $210,113.75.

Fowler used the proceeds of the loan as follows: (a) $210,000 in payment of the loan to Chemical Bank; (b) $50,000 used to purchase the non-interest bearing certificate of deposit; and (c) $5,000 used by Fowler to open a checking account at plaintiff bank. The remainder was sent by plaintiff to Fowler's checking account in New York from which the following disbursements were made: (a) $45,000 used to purchase preferred stock in Love and Co. to provide working capital for that company; (b) $12,000 was paid to Pettit and McNutt as a finder's fee for arranging the loan; and (c) $25,000 was used in payment of a

loan that Fowler had previously made on behalf of Love and Co.

Even if the loan by plaintiff did not mathematically violate Regulation U, both defendants argue that the loan to Fowler by Chemical Bank was in violation of Regulation U; and that since $210,000 of the People Bank loan was used to pay off Chemical Bank, therefore, the loan by plaintiff also violates Regulation U.

12 CFR §221.3(b)(1) and (2) provide: "The 'purpose of a credit' is determined by substance rather than form. ° ° ° (2) Credit to enable the customer to reduce or retire an indebtedness which was originally incurred to purchase a margin stock is for the purpose of carrying such a security."

It is quite clear therefore that if the original loan by Chemical was in violation of Regulation U, and the plaintiff's loan was to retire such indebtedness, then plaintiff's loan, of necessity, by the terms of the regulation, is likewise a violation. *Serzysko v. The Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y. 1968), aff'd. 409 F2d 1360 (2d Cir.), cert. denied 396 U.S. 904, 90 S.Ct. 218, 24 L.Ed. 2d 180 (1969).

At the time of the Chemical Bank loan (May 6, 1970) a share of Jeannette Stock traded at a high of 16⅛ (New York Times, May 7, 1970, p. 75). The value of the 24,013 shares of Jeannette Stock amounted to $387,329.69, with 35% of that value equalling $135,565.39. Accordingly, I find that the Chemical Bank loan of $250,000 clearly violated Regulation U and that the $210,000, a portion of the $350,000, which was paid by plaintiff to Chemical Bank in order to retire that loan also violated Regulation U. The loan by plaintiff was used to retire an indebtedness which violated Regulation U.

It accordingly becomes unnecessary to determine whether the loan of $300,000 by plaintiff to Fowler was an additional or separate violation of Regulation U. It is to be noted that 35% of the value of the collateral stock on March 1, 1971, was $210,113.75. Only $210,000 went to Chemical. I do not decide whether or not the other sources to which the $300,000 loan were applied in and of themselves would bring the total amount advanced on margin above the 35% limit.

Plaintiff contends that certain "Exceptions to the General Rule" as set out in Section 221.2 make this an exempt transaction. I do not agree. The exemptions provided therein do not include the type of transaction with which we are here concerned.

I hold that the amount of the loan made by plaintiff was in violation of the requirements of Regulation U in effect on March 1, 1971.

The regulation places the entire burden of observing the margin requirement on the lender (*Seryzsko v. Chase, supra*). In that regard certain regulations have been adopted.

Section 221.3(a) of Regulation U provides in part as follows:

> "° ° ° In determining whether or not an extension of credit is for the purpose specified in §221.1°°°the bank may rely on the statement executed by the customer if accepted in *good faith*. To accept the customer's statement in good faith, the officer must (1) be alert to the circumstances surrounding the credit and (2) if he has any information which would cause a prudent man not to accept the statement without inquiry, have investigated and be satisfied that the customer's statement is truthful." (Emphasis added.)

Section 221:101(c) provides that:

"(c) Certain facts should also be mentioned regarding the determination of the purpose of a loan. Section 221.3(a) provides in that connection that a bank may rely upon a statement with respect thereto, accepted by the bank in good faith, signed by an officer of the bank or by the borrower.' The requirement of 'good faith' is of vital importance here. Its application will necessarily vary with the facts of the particular case, but it is clear that the bank must be alert to the circumstances surrounding the loan."

Section 221.106 paragraphs (d) and (h) provide:

"(d) Furthermore, the same requirement of 'good faith' is to be applied whether the statement accepted by the bank is signed by the borrower or by any officer of the bank. In either case, 'good faith' requires the exercise of special diligence in any instance in which the borrower is not personally known to the bank or to the officer who processes the loan.

• • •

(h) These examples are, of course, by no means exhaustive. They simply illustrate the fundamental fact that no statement accepted by a bank is of any value for the purposes of the regulation unless 'accepted by the bank in good faith', and that 'good faith' requires, among other things, reasonable diligence to learn the truth."

According to the aforequoted sections of Regulation U, a bank does not discharge its burden of complying with Regulation U by merely obtaining a statement of purpose

from the borrower. It must exercise "reasonable diligence to learn the truth." 12 CFR §221.106(h). Plaintiff herein made no effort to inquire of the Chemical Bank why it was demanding payment on its note. It made no other independent inquiry of Fowler's background. It merely asked Fowler for a statement of his worth. Fowler did acquaint plaintiff's officers with the purpose of the loan. The purpose statement is totally blank and failed to specify the details of the loan. Accordingly, I find that plaintiff failed to exercise good faith in investigating the background and purpose of this transaction in violation of Regulation U.

Both defendants, Fowler and Stonehill, argue that this transaction is void. That Fowler can keep the balance of the $300,000 loan and need not repay it. Stonehill further argues that since the transaction is void, his stock should be returned to him.

Plaintiff argues that Stonehill has no standing to raise the issue of this violation of Regulation U. At the time of the making of this loan Stonehill had no connection with the transaction other than his ownership of the stock which was pledged. He did not participate in any of the negotiations preceding the loan. He is a mere stranger to the entire transaction.

In *Natkin v. Exchange National Bank of Chicago*, 342 F.2d 675 (7th Cir. 1965), an action was brought by George and Tillie Natkin against the Exchange National Bank of Chicago, alleging that the bank made loans to Ben Natkin in violation of Regulation U. Ben Natkin had obtained the stock from George and Tillie Natkin and deposited the stock as collateral for the loan. The stock certificates were endorsed in blank by the plaintiffs to make them readily negotiable in the event that the bank chose to sell such collateral. There was nothing in the proofs to in-

dicate that the bank in any way participated in the arrangement between the plaintiffs and Ben Natkin. The court held that persons who have their stock endorsed in blank to a borrower who pledged the same with the bank as collateral were strangers to the contract between the bank and the borrower and could not recover from the bank for its alleged violation of Regulation U.

I find this case to be persuasive authority.

One who furnishes collateral endorsed in blank, and closes his eyes to the transaction or manipulation in which the securities are used has no standing to complain if a loss is sustained.

It must be remembered that Stonehill loaned the stock to Fowler. It was Fowler who violated Stonehill's desires to have his stock back in six months.

Further, Fowler knew at the time of his negotiations with the bank that he was then about to violate Regulation U. Stonehill's recourse is against Fowler not the bank.

I hold that Stonehill has no standing to raise the issue of violation of Regulation U as an issue.

The defendants argue that a loan made in violation of Regulation U is void.

The defendants argue on the strength of the case of *Cooper v. Union Bank*, 354 F.Supp. 669 (C. D. Cal. 1973) that the bank's rights under the loan contract should be voided and the unpaid balance and interest due thereon should be cancelled.

The basic weakness in the argument is that the court there was speaking of the right of an *innocent party* to have the transaction voided.

Fowler's background and his frank admission in court that he knew the transaction violated Regulation U does not qualify him to be an innocent party within the language of either the statute or that case.

Defendants also rely heavily on *Serzysko v. The Chase Manhattan Bank*, 290 F. Supp. 74, (S.D.N.Y. 1968), *aff'd* 409 F.2d 1360 (2d Cir.), *cert. denied*, 396 U.S. 904, 90 S. Ct. 218, 24 L.Ed. 2d 180 (1969). The Court there held that a transaction which violates Regulation U is void. *Serzysko v. The Chase Manhattan Bank, supra*, involved a loan by a bank to a sophisticated investor who was well aware of the provisions of Regulation U. The borrower defaulted on his loan and the bank liquidated the pledged securities. Thereupon, the borrower sued the bank for damages. The bank counterclaimed for the balance of the loan which was not satisfied from the sale of the pledged securities. The Court denied the relief requested by the plaintiff as well as the relief requested by the bank. It also held that contracts in violation of Regulation U were void.

Plaintiff argues that Fowler should be estopped from raising the defense of Regulation U because he testified that he was of the opinion that the loan with plaintiff was in violation of Regulation U and did not advise plaintiff that he thought the loan was in violation of Regulation U.

In *Serzysko v. The Chase Manhattan Bank, supra*, the defendant bank contended that the borrower's conduct in connection with the loan transaction, that is, his misrepresentations as to the use of the loan; should bar him from any recovery under 15 U.S.C.A. §78cc(b). The Court was of the view that notwithstanding the fact that the borrower was a sophisticated investor he was not for that reason barred from bringing his action for damages and it rejected the bank's "in pari delicto" argument. The court's language is significant, at page 89:

"° ° ° If an investor-borrower could by means of false representations and statements mislead a lender into making a loan for the purchasing or carrying of registered securities when the lender did not know or intend that the loan would be used for such purpose, and then recover heavy damages from the lender on the basis that the lender in the exercise of reasonable diligence should have discovered the deceit, there would be encouragement for an investor-borrower to engage in the practice which, in substance, would be that so far as the investor-borrower is concerned he could keep the profits if his speculation proved probitable and have the lender bear the loss if the speculation proved unprofitable.

In some of the cases referred to reference is made to the doctrine of in pari delicto which is said to literally mean "of equal fault." The term in pari delicto has been applied to a variety of situations. It is the view of the Court that whatever the scope that doctrine may be it can hardly be said that one who is deceived by false representations of another can be said to be in pari delicto with him because of the fact that the deception might have been discovered in the exercise of reasonable diligence.

° ° °

It is the view of the Court that to allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act ° ° °."

The defendants argue that plaintiff failed to exercise reasonable diligence in investigating the background of Fowler and the purpose for which se was making the loan,

that if they had made inquiry of the details of the Chemical Bank loan they would have discovered that this loan was in violation of Regulation U. Not having done so, defendant contends, makes them in pari delicto with Fowler. I do not agree.

In *Goldman v. Bank of the Commonwealth*, 467 F2d 439 (6th Cir. 1972) the borrower sought to declare void loans made to him by the bank in violation of Regulation U. The trial court allowed the bank to recover the actual money loaned without interest and gave credit to the borrower for the value of the pledged securities. The Court of Appeals affirmed, stating:

"° ° ° Although Congress specifically provided a civil remedy for violation of 15 U.S.C.A. §77e in 15 U.S.C.A. §771(1), no such remedy was expressly provided for a violation of section 10(b) of the 1934 Act. Since civil liability was judicially implied, the appropriate common law defenses should be applicable. It would be inconsistent to apply these defenses to a remedy specifically provided by Congress and not to a remedy judicially inferred from an act of Congress. Since courts generally interpret statutes in the context of the common law and Congress has not specifically denied the availability of these defenses, we see no reason why the ordinary defenses of estoppel and waiver should not be applicable. The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocense and then waits to see how his investment turns out before he decides to invoke the provisions of the Act. (Citations omitted.)

° ° °

The Courts have not particularly favored a person who seeks to avoid payment of his debts by asserting the defense of illegality. (Citations omitted.)

We do not regard the Bank as being in pari delicto with Goldman. We here are dealing with a financial institution; a source of the money which it loaned to Goldman was the deposits with it by its customer-depositors. Goldman was the aggressor in the loan transactions. He sought to get rich quick by wild speculations in stock of a company in which his father-in-law held securities, and which company has so-called tremendous potential.' The Bank collected only interest for making the loans. If the stock had gone up, as Goldman envisioned, he would have been a rich man. The Bank would not have participated in his riches, as it received only interest. Goldman's conduct in imposing on the Bank has been heretofore related. The worst that can be said about the Bank is that it did not exercise ordinary banking procedures, which would have prevented it from being 'taken'.

In Restatement of the Law, 'Contracts', §604, page 1120, it is stated:

'Recovery by a Party Not in Pari Delicto:

'Where the parties to an illegal bargain, though both blameworthy, are not in pari delicto, and one of them has not been guilty of serious moral turpitude, he can repudiate the bargain, and if he has rendered any performance thereunder, recover it or its value.

Illustrations: '1. A deposits in B, a bank, money on terms violating the banking law, as both A and B are aware. A can recover the money.' "

Cf. *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968); *Aubin v. H. Hentz & Co.*, 303 F. Supp. 1119 (S.D. Fla. 1969).

It is to be noted in that case that the court viewed the bank as having a cause of action on either of the two grounds separate and apart from the Securities Act and not voided by it: (a) action to recover monies lent; and (b) misrepresentation.

Admittedly, the conduct of the borrower in *Goldman v. Bank of the Commonwealth, supra,* was more deceitful than that of John Fowler. In *Goldman,* there was deceitful conduct. Here, Fowler failed to disclose his knowledge of the illegality of the loan in relation to Regulation U.

This Court is well aware of the authorities which hold that the Congressional policy behind the Securities Exchnage Act of 1934 in guarding the public against abuses in the securities arena is too strong to deny judgment to a borrower who seeks to declare a loan transaction void because of a violation of the Securities Exchange Act. *Perlstein v Scudder & German,* 429 F.2d 1136 (2d Cir. 1970); *Avery v. Merrill, Lynch, Pierce, Fenner & Smith,* 328 F. Supp. 677 (D.C.D.C. 1971); *Courtland v. Walston & Co., Inc.,* 340 F. Supp. 1076 (S.D.N.Y. 1972); *Serzysko v. The Chase Manhattan Bank, supra.*

However, other courts of equal statute have rejected the "in pari delicto" argument and have not permitted a borrower to gamble upon the success of a venture and then, upon losing, assert the defense of illegality to avoid the payment of his debts. *Goldman v. Bank of the Commonwealth, supra; Naftalin v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* 469 F.2d 1166 (8th Cir. 1972).

See also the strong dissent of Friendly, C. J., in *Perlstein v. Scudder & German,* 429 F.2d 1136, 1145 (2d Cir. 1970).

Fowler in this action basically seeks to rescind his contract with the bank. One of the basic conditions prece-

dent to an action for rescission is that the party seeking recission tender back the considerations received by him.

Further, this is a court of equity. To permit Fowler to retain the balance of the $300,000 would shock the conscience of the Court and do violence to basic concepts of fairness, morality and justice.

To permit Fowler to retain the fruits of his illegal act and return to Stonehill his collateral would do violence to the public policy of the Securities Act. To compel Fowler to meet his obligations to plaintiff will advance the public policy of protecting the investor and inhibiting such action in the future by other shrewd brokers far more than letting Fowler go his way, $300,000 rich for his illegal act.

Judgment will be entered for plaintiff against Fowler for the balance due on the loan after crediting against the principal all payments heretofore made. The plaintiff-bank is to have no interest on the transaction.

Plaintiff may have recourse to the collateral in its possession and sell the same in accordance with pertinent statutes and regulations relating to control stock. Defendant Stonehill is directed to remove any restrictions he may have placed on the sale or transfer of the stock.

There will be a judgment entered in favor of plaintiff on the counterclaim filed by Stonehill seeking return of the pledged stock.

A judgment will be entered in favor of Stonehill and against Fowler on the crossclaim filed by Stonehill seeking damages for losses sustained as a result of the sale or other disposition of the pledged stock. That judgment shall be in an amount of the judgment in favor of plaintiff and against Fowler, less the value of any stock not required

to be sold to satisfy the judgment and returned to Stonehill. The value of the stock for this purpose is to be its market value as of the date it is returned to Stonehill. It necessarily follows that the amount of this judgment will have to abide the event.

The parties having made known to me their intention of taking an appeal, the final judgment may provide for a stay of execution pending appeal and may also provide that Stonehill be permitted to continue to treat the pledged securities as his own for purposes of voting said shares and conducting the affairs of the Jeannette Glass Company.

Please submit the form of judgment.

APPENDIX D

ON PETITION FOR CERTIFICATION
(Filed June 4, 1975)

To Appellate Division, Superior Court:

A petition for certification having been submitted to this Court, and the Court having considered the same,

It is hereupon ORDERED that the petition for certification is denied with costs.

WITNESS, the Honorable Richard J. Hughes, Chief Justice, at Trenton, this 4th day of June, 1975.

/s/ Florence R. Peskoe

FLORENCE R. PESKOE
Clerk

A True Copy

/s/ Florence R. Peskoe
Clerk

APPENDIX E

ORDER
(Filed September 16, 1975)

This matter having been duly presented to the Court, it is ORDERED that the motion for reconsideration is granted; and it is further

ORDERED that the petition for certification is granted.

WITNESS, the Honorable Richard J. Hughes, Chief Justice, at Trenton, this 16th day of September, 1975.

/s/ Florence R. Peskoe

FLORENCE R. PESKOE
Clerk

A True Copy

/s/ Florence R. Peskoe
Clerk

APPENDIX F

ORDER
(Filed July 12, 1976)

This matter having been duly considered by the Court, it is ORDERED that the grant of certification as to John B. Fowler, Jr., is hereby vacated.

WITNESS, the Honorable Richard J. Hughes, Chief Justice, at Trenton, this 12th day of July, 1976.

/s/ Florence R. Peskoe

FLORENCE R. PESKOE
Clerk

A True Copy

/s/ Florence R. Peskoe
Clerk

APPENDIX G

ORDER
(Filed May 5, 1976)

This matter having been duly considered by the Court, it is ORDERED that the order of this Court dated September 16, 1976 granting certification is modified and the certification is limited to consideration of whether there has been a violation of Regulation U and, if there has been, whether Maurice L. Stonehill is entitled to recover his stock; and it is further

ORDERED that appellants may serve and file supplemental briefs on the above issues within 30 days of the date hereof and respondent may serve and file a supplemental brief in response within 30 days thereafter.

WITNESS, the Honorable Richard J. Hughes, Chief Justice, at Trenton, this 5th day of May, 1976.

/s/ Florence R. Peskoe

FLORENCE R. PESKOE
Clerk

A True Copy

/s/ Florence R. Peskoe
Clerk

Supreme Court, U. S.
FILED
AUG 9 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-111

PEOPLES NATIONAL BANK OF NEW JERSEY,
Petitioner,

vs.

JOHN B. FOWLER, JR.

and

MAURICE L. STONEHILL,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE
SUPREME COURT OF NEW JERSEY

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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JURISDICTION

Petitioner has sought to invoke the jurisdiction of this Court under 28 U.S.C.A. Section 1257(3) contending that there is a federal question. Respondent submits that jurisdiction is lacking in this case because the decision of the Supreme Court of New Jersey rests upon non-federal grounds and said decision is not properly reviewable in this Court. This point is pursued more fully in the Argument that follows.

QUESTIONS PRESENTED

1. Whether the following determination of the Supreme Court of New Jersey:

> Where an uncompensated guarantor's obligation contemplated a bank loan that would be made in accordance with the law and a bank enters into a loan contract violating both the State's usury law and the U.S. Securities Exchange Act of 1934, the Bank's violation discharges the guarantor's obligation and the owner of stock pledged as collateral is entitled to the return of that collateral

can or should be reviewed by this Court?

2. Whether the jurisdiction of this Court can be invoked properly where the above-stated final decision of the State Court rests on grounds which are non-federal in character or upon two grounds—one of which is non-federal in character and sufficient to sustain the determination below?

STATEMENT

Most of the applicable facts of this case are stated sufficiently in the decision of the Supreme Court of New Jersey (Petitioner's Appendix A at 1a to 7a).

To assist the Court in its consideration of this matter, however, we would emphasize the following specific points:

1. This is a suit which was originally instituted by petitioner in the State courts of New Jersey. Defendant, Fowler, removed the case to the Federal courts on the grounds of diversity of citizenship. Petitioner resisted this removal and the case was then remanded to the State court (Petitioner's Appendix C at 24a, fn. 1).

2. Respondent Stonehill filed an action in the United States District Court and sought to enjoin proceedings before the State court before the trial of this matter. The injunction was denied (Petitioner's Appendix C at 24a fn. 1).

3. Respondent Stonehill also moved, before the trial of the matter, to have the matter dismissed by the State court on the grounds that jurisdiction was properly in the Federal courts because of the alleged violations of the Securities Exchange Act of 1934. Petitioner also opposed this effort of defendants. The trial court reserved decision on this motion until the completion of the trial at which time it issued an opinion that the State court had jurisdiction to hear the matter (Petitioner's Appendix C at 24a to 26a).

4. The question passed upon by the Supreme Court of New Jersey was stated by that Court to be:

> "Is an owner of stock, which had been transmitted to a bank as collateral security for a loan to a third person, entitled to the return of the stock because in

making the loan the bank violated the Federal margin requirements of Regulation U, 12 C.F.R. Section 221.1 *et seq.* (1976), and the Usury Law of New Jersey, N.J.S.A. 31:1-1 et seq.?" (Petitioner's Appendix A at 1a)

5. As the opinion of the State Supreme Court indicates, the trial court found Regulation U had been violated and on oral argument before the Supreme Court petitioner conceded that violation. The question as to whether there was a violation of Regulation U was therefore not addressed by that Court but accepted as a fact (Petitioner's Appendix A at 2a, fn. 1).

6. The Supreme Court of New Jersey made the following determination with regard to the above question:

"It is a general rule that, if the condition upon which the guarantor agrees to become bound is not complied with, the guarantor is discharged. *Brandt, Law of Suretyship and Guarantee*, Section 350, at 471 (1878). We find that where the uncompensated guarantor's obligation contemplated a bank law which would be made in accordance with the law, the bank's violation discharges that obligation and the pledgor is entitled to the return of his stock." (Petitioner's Appendix A at 14a)

The opinion of the State Supreme Court also notes at that point that a comparable rule may be found in Section 124(1) of the *Restatement of Security* (1941), which states:

"Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increased the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety."

ARGUMENT

Respondent submits that this Petition for a Writ of Certiorari should be denied:

Because the State court decision here under review rested upon grounds which are essentially non-federal in character and said decision is not dependent upon a federal ground for its substantiation;

The assertion that the State court decision extended the application of 15 U.S.C.A. Section 78cc(b) to one *not in privity of contract* with a lending bank is contrary to the determination reached by the State court and such a determination, whether factual or legal in nature, is essentially non-federal in character and not subject to review (Petitioner's Appendix A at 8a);

Petitioner's contention that the State trial court decision is contrary to the determination in *Natkin v. Exchange National Bank of Chicago*, 342 F.2d 675 (7th Cir. 1965) is not correct and such an issue, in any event, does not warrant review by this Court under the facts of this case.

1. *The absence of a non-federal question.*

It is clear beyond question that the jurisdiction of this Court cannot be invoked in the fashion here attempted by petitioner in the absence of a federal question. Moreover, where the judgment of a State court rests upon two grounds, one of which is federal and the other non-federal in character, this Court is also without jurisdiction to review if the non-federal ground is independent of the federal ground and adequate to support the judgment. This is true even if the State court may have also summoned to its support an erroneous view of federal law. *Radio Station WOW v. Johnson*, 326 U.S. 120, 65 S. Ct. 1475 (1945); *Jankovich v. Indiana Toll Road Com.*, 379 U.S. 487, 85 S. Ct. 493 (1965); *Henry v. Mississippi*, 379

U.S. 443, 85 S. Ct. 564 (1965), 32 Am. Jur. 2d Federal Practice and Procedure, Section 243.

In this case, the State Supreme Court posed very clearly the question it was passing upon and its response to that question is equally clear. In essence, the New Jersey Court determined, under its interpretation of general doctrines of the law of suretyship and guarantee, that an owner of stock which has been transmitted to a bank for collateral security for a loan to a third person is relieved from his surety or guarantor obligations where the bank has violated certain provisions of the law in making the loan to the third person. Herein, the actual violation of Regulation U of the Securities Exchange Act of 1934 as well as the usury laws of the State of New Jersey.

In the above holding, the State court opinion does not rest upon the provisions of the Securities Exchange Act of 1934 or more specifically the provisions of that Act concerning violations set forth in 15 U.S.C.A. Section 78cc(b). There is nothing in the opinion below to sustain petitioner's contention that the State court decision here under review rested upon or was dependent upon the application of this section of the federal law. Indeed, the decision below indicates specifically that it is grounded on doctrines of suretyship and guarantee as is revealed by the citations of the court to *Brandt, supra,* and the Restatement of Security (Petitioner's Appendix A at 14a).

The State court had full right and power to determine the application of these doctrines to the loan transaction in question and such concepts of contract and surety law are so essentially non-federal in character so as not to sustain a review of this matter by this Court under the provisions of 28 U.S.C.A. Section 1257(3).

2. *The issue as to privity of contract.*

In seeking to fabricate the contention that there is a federal question here present which would enable petitioner to at least cross that threshold issue, petitioner has asserted that the State court decision here under review "extended the application of 15 U.S.C.A. Section 78cc(b) to one not in privity of contract with a lending bank" (Petitioner's brief p.8).

The issue of privity of contract, as the words imply, is basically a question of contract law. It is also a question of fact. These questions, however, are not essentially federal in character. Moreover, the determinations made by the State court below on these questions are not only correct but are also so narrow and unique to the state of facts present in this case so as not to warrant the attention of this Court.

The response to petitioner that no privity of contract existed in this case is best answered by the opinion of the Supreme Court of New Jersey which states:

> "The factual conclusion that Stonehill had no contractual or other legal relationship with PNB is belied by the undisputed facts. PNB knew that the stock which was being pledged by Fowler was owned by Stonehill. This was evident from Fowler's February 24, 1971 letter to Rohrer (which was received before the loan agreement was made on March 1) in which Fowler advised Rohrer that not only was the stock owned by Stonehill but also that Stonehill was a controlling stockholder. Because this was control stock, under Rule 154 of the Securities and Exchange Commission, promulgated pursuant to the Securities Act of 1933, only limited quantities could be sold on the American Stock Exchange, where the stock was listed, every six months 19 Fed. Reg. 9375-9376 (1954). Furthermore, at the closing PNB received a letter

> signed by Stonehill in which he authorized the use of the stock as collateral for the loan. And Francis Mason, PNB's Vice-President, was advised by Chemical of the stock's status when arrangements were being made for transmittal of the stock certificates and satisfaction of the Fowler indebtedness to Chemical.
>
> Stonehill was joined as party defendant to this litigation because PNB recognized that he was a necessary party. Stonehill's interest in the transaction, as owner of the pledged stock and as surety or guarantor to the extent of the pledged stock, is apparent."

The Court opinion goes on at some length to review the legal rights that Stonehill had by virtue of his position as a surety or guarantor with regard to the lending bank. Its conclusion that Stonehill had standing to raise defenses and assert his claim to the stock is not grounded upon an interpretation of federal law and such a finding. whether deemed to be factual or legal in nature, is not subject to dispute before this Court. *Neblett v. Carpenter*, 305 U.S. 297, 59 S. Ct. 170.

As a final point, the determination by the State Supreme Court in this matter on this issue of privity of contract is so patently correct that even if this were deemed to be a reviewable question, petitioner has most obviously failed to set forth a justification for a review of the matter.

3. *The decision below does not conflict with the* Natkin *decision in such a manner as to justify a review of this case.*

Assuming *arguendo* that petitioner can satisfy this Court with regard to the threshold issues set forth in Points I and II hereof, its contentions that the New Jersey decision conflicted with the determination in *Natkin v. Ex-*

change National Bank of Chicago, supra, is without foundation.

In *Natkin*, it was conceded by the parties that there was "no contractual relationship between the bank and the plaintiffs and that the plaintiffs are strangers to the loan transaction . . ." 342 F.2d *supra* at 676. The case was decided on this agreed statement of facts.

Unlike the situation in *Natkin*, the lending bank in this case was well aware of Mr. Stonehill's ownership of stock and the fact that it was control stock. Moreover, respondent's stock was pledged as collateral by a written hypothecation agreement from Stonehill to the lending bank (Petitioner's Appendix A at 11a). No such similar situation existed in *Natkin*.

In *Natkin*, the owners of the collateral stock were true strangers to the transaction. They permitted the borrower to deal with the bank under circumstances where the bank had no basis for assuming that anyone other than the borrower was the owner of the stock. There was no recognition in *Natkin*, as is the case here, of a third party ownership of the stock and no comparable relationship between the lending bank and the stock owner by way of hypothecation agreement. The New Jersey's Courts determination, therefore, that *Natkin* was distinguishable from the present situation therefore was correct and certainly does not raise such an issue of federal law that would warrant further review by this Court. Additionally, the interpretation of *Natkin* followed by the New Jersey Court was clearly in accord with federal law.

Although petitioner has cited in its petition *Levin v. Great Western Sugar Co.*, 274 F. Supp. 974 (D.C.N.J. 1967) and *East Side Church of Christ v. National Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968), it has conveniently neglected to note that both of these decisions are con-

sistent with or supportive of the interpretation followed by the Court below. In *East Side, supra,* the Circuit Court of Appeals expressly recognized the right of the equitable owners of securities to maintain an action under the Securities Exchange Act of 1934 although these owners did not participate in the transaction between their agent and the broker to whom he sold the securities. 391 F.2d *supra* at 362.

The decision in *Levin, supra,* is also consistent with the interpretation of *Natkin* by the Court below. In *Levin,* the stockholders of one company involved in a proposed merger of corporations sought to attack certain loans made to the corporation seeking to acquire the company in which they held stock. Neither these stockholders nor their company were parties to the loans made by the banks to the other company. Under these circumstances, the stockholders were held to be strangers to the bank loan transactions. In explaining its ruling, the Court states at 274 F. Supp. 979:

> "Although it could be argued that the privity requirements enunciated in those cases are ripe for change, or for waiver in the present case, two considerations compel an opposite conclusion: (a) the plethora of suits against banks that might follow from a relaxation of the rule, and the consequent adverse effect on banking and commerce, (b) the fact that, in any event, the facts of the present case do not indicate that a waiver of the rule for the present plaintiff would be proper or equitable at the present time."

The reference to the plethora of suits clearly underscores the rationale of the *Natkin* decision. If individuals who are not connected with bank loan transactions could, after the fact, litigate whether the loans violated the federal law, there is a clear danger of extensive litigation.

The present situation is clearly distinguishable. Defendant Stonehill was, in fact, a party to the loan transaction by virtue of his hypothecation agreement with the bank. The interpretation followed by the State Court is clearly consistent with all federal decisions on this point.

It should be apparent, therefore, that petitioner is seeking to litigate an issue which is essentially non-federal in character. To the extent that it may be concluded an interpretation of the Securities Exchange Act of 1934 is involved in the decision below, however, the interpretation followed by the State Court is consistent with the federal decisions on the point. Although the Supreme Court of New Jersey's decision is not dependent upon an interpretation of *Natkin* or upon the remedy set forth in 15 U.S.C.A. Section 78cc(b), the decision below is fully consistent with existing federal decisions in these areas.

As a final note, petitioner has challenged the role played by the New Jersey Court in this matter. It should be noted that petitioner repeatedly resisted efforts by the defendants below to place this matter before the Fedral courts. It actively sought State court review. It should not be permitted to use the involvement of the State courts in a "federal" matter as part of the rationale for review by this Court.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari that has been filed in this case should be denied.

Respectfully submitted,

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